

Message Text

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PAGE 01 LONDON 14244 01 OF 03 170509Z

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TREASURY DEPT WASHDC

C O N F I D E N T I A L SECTION 01 OF 03 LONDON 14244

LIMDIS GREENBACK

C O R R E C T E D C O P Y (TEXT-SUMMARY-LINE OMITTED)

DEPARTMENT PASS FRB

E.O. 11652: XGDS-1

TAGS: EFIN, UK

SUBJECT: H.M. TREASURY AND BANK OF ENGLAND ON INTERNA-
TIONAL MONETARY MATTERS

SUMMARY: DURING DISCUSSIONS WITH FINANCIAL ATTACHE ON
SEPTEMBER 8, SENIOR OFFICIALS IN H.M. TREASURY AND BANK
OF ENGLAND EXPRESSED UNCERTAINTY AND NO PARTICULAR CONFI-
DENCE ON THE POUND, BALANCE OF PAYMENTS DEVELOPMENTS, AND
DOMESTIC ECONOMIC TRENDS. THEY ARE CONCERNED OVER EXTER-
NAL FINANCING PROSPECTS THROUGH 1978. NO PAPER
HAS YET BEEN PUT TO THE CHANCELLOR FOR A DECISION ON TI-
MING AND MAGNITUDE OF THE POTENTIAL IMF DRAWING TO RE-
PLACE THE \$5.3 BILLION STANDBY MATURING IN DECEMBER. END
SUMMARY.

1. SENIOR OFFICIAL IN H.M. TREASURY SEES THE COMING
MONTHS AS A PERIOD OF UNCERTAINTY AND CONCERN FOR THE UK
IN FOREIGN EXCHANGE MARKETS. THERE IS STILL NO BASIC
CONFIDENCE IN THE POUND. THE MARKET HAD STABILIZED SINCE
THE END OF JUNE (UNTIL SLIDE ON SEPTEMBER 9) ASIDE FROM
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PAGE 02 LONDON 14244 01 OF 03 170509Z

ISOLATED FLURRIES. THERE APPEARS TO BE FEELING THAT THE

GOVERNMENT'S POLICY INTENTIONS ARE CORRECT BUT THERE IS A LACK OF CONFIDENCE IN THE GOVERNMENT'S ABILITY TO CARRY THEM OUT. INDUSTRIAL UNREST SUCH AS THAT AT LEYLAND OR THE PROPOSED DOCKERS STRIKE MOVE THE MARKET. SWISS BANKS CONTINUE TO TAKE BEAR POSITIONS ON STERLING. (THE POUND HAS ALSO WEAKENED ON OCCASION IN SYMPATHY WITH PRESSURE ON FRENCH FRANC.) IT IS ALSO THE "SILLY SEASON" WITH POSTURING AT THE TUC CONFERENCE THIS WEEK. THE FORTHCOMING LABOUR PARTY CONFERENCE AT MONTH'S END MAY NOT BE HELPFUL, AS DIVISIVE STATEMENTS ARE BOUND TO BE MADE. THE LABOR PARTY NATIONAL EXECUTIVE COMMITTEE'S STATEMENT CALLING FOR NATIONALIZATION OF THE BIG FOUR BANKS AND TOP SEVEN INSURANCE COMPANIES HAD A NEGATIVE IMPACT ON THE MARKET. IN ADDITION, IN THE RUN UP TO THE LABOR PARTY CONFERENCE, MINISTERS BECOME MORE POLITICAL IN THEIR THOUGHTS. IT BECOMES HARDER TO GET THEIR ATTENTION FOR DECISIONS.

2. BALANCE OF PAYMENTS TRENDS, LOOKING AHEAD FOR THE NEXT 12-18 MONTHS, ARE NOT LIKELY TO SHOW MUCH IMPROVEMENT, MONTHLY FIGURES WILL VARY, WITH SOME AMELIORATION IN SELECTED MONTHS. THIS RAISES THE PROBLEM OF FINANCING THE DEFICIT, UNTIL SIGNIFICANT PROGRESS ON CURRENT ACCOUNT IS SEEN IN 1978. THE UK TREASURY'S NEXT MAJOR FORECAST IS NOT DUE UNTIL LATE OCTOBER. SOURCE COULD NOT QUANTIFY, BUT SAW ONLY SLOW IMPROVEMENT IN BALANCE OF PAYMENTS DUE IN PART TO HIS EXPECTATION OF A CONTINUING DELAY IN THE REDUCTION OF THE RATE OF INFLATION BELOW 10 PERCENT.

3. THE DECEMBER 9 MATURITY DATE FOR REPAYMENT OF THE \$5.3 BILLION CREDIT LINE IS "INDELIBLY ETCHED" ON THE MINDS OF HMT OFFICIALS AND "EVEN MORE SO" AT THE BANK OF ENGLAND. ALTHOUGH \$1.03 BILLION WAS USED IN JUNE, HMT VERY MUCH HOPES TO MINIMIZE FURTHER DRAWINGS.

4. SOURCE SAID NO DECISION PAPER HAS YET BEEN PREPARED FOR THE CHANCELLOR ON WHETHER AND WHEN TO GO TO THE IMF. HMT SENIOR POLICY OFFICIALS HAVE NOT DECIDED AMONG THEMSELVES WHAT THE BEST TIMING WOULD BE, BUT SOME OF THESE SENIOR OFFICIALS CONSIDER THAT THE IMF PRESENTS THE CONFIDENTIAL

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PAGE 03 LONDON 14244 01 OF 03 170509Z

CHEAPEST SOURCE OF FUNDS AVAILABLE AND THAT IT IS IN THE UK'S BEST INTEREST TO GO TO THE FUND AS SOON AS POSSIBLE-- "THE SOONER THE BETTER." THIS WOULD CLARIFY THE SITUATION. DEMANDS FOR CONDITIONALITY MUST BE EXPECTED AND THE TERMS WOULD BE KNOWN TO BOTH SIDES. BETWEEN NOW AND NEXT SPRING, ANY TIME IS AWKWARD. THE IMF ANNUAL MEETING IS IN MID OCTOBER; THE UK'S OWN ECONOMIC FORECASTS WILL NOT BE AVAILABLE UNTIL LATE OCTOBER. NEGO-

TIATIONS WITH THE FUND COULD BEGIN IN NOVEMBER AT THE EARLIEST AND WOULD PROBABLY TAKE 6 WEEKS. THE G-10 AND GAB WOULD BE INVOLVED. THE CREDIT REPAYMENT IS DUE ON DECEMBER 9. THERE COULD BE TIMING PROBLEMS WITHIN THE

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PAGE 01 LONDON 14244 02 OF 03 091808Z

44

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C O N F I D E N T I A L SECTION 02 OF 03 LONDON 14244

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MONTH OF DECEMBER IF IMF FUNDS WERE TO BE USED TO REPAY THE SWAP LINE. EQUALLY, RESERVES COULD BE USED TO BRIDGE THE GAP ALTHOUGH THESE ARE AT LOW LEVEL. IF AN IMF DRAWING WERE TAKEN BEFORE THE END OF THE YEAR, THE LEVEL OF THE RESERVES IN PUBLISHED DATA WOULD NOT SHOW A DECLINE.

5. THE SOURCE ASKED THE FINANCIAL ATTACHE FOR HIS VIEWS ON HOW THE IMF OR G-10 WOULD VIEW A UK REQUEST FOR A LENDING OPERATION. FINANCIAL ATTACHE, SPEAKING PERSONALLY, REPLIED THAT REACTION WOULD DEPEND SIGNIFICANTLY ON POLICIES BEING FOLLOWED, THE POSSIBILITY OF THEIR SUCCESS, AND ON THE LEVEL OF CONDITIONALITY THAT WOULD BE READILY ACCEPTED BY THE UK. IN REPLY SOURCE AGREED FURTHER CONDITIONALITY WOULD BE REQUIRED. THE UK'S PROGRAM MUST BE CONVINCING.

6. TIMING OF POTENTIAL IMF BORROWING IS VERY MUCH IN MINDS OF UK OFFICIALS, GIVEN POSSIBILITY OF ADDITIONAL 45 PERCENT ACCESS TO REGULAR IMF CREDIT FACILITIES PRIOR

TO IMPLEMENTATION OF PROPOSED QUOTA INCREASE, AT WHICH TIME UK'S MAXIMUM QUOTA INCREASE WOULD RISE LESS THAN 5 PERCENT (I.E., FROM 2.8 TO 2.925 BILLION SDR). IF DECISION WERE TAKEN TO GO TO THE IMF, SOURCE COULD SEE NO REASON NOT TO REQUEST ALL THE REMAINING TRANCHES INCLUDING THE ADDITIONAL 45 PERCENT IN ORDER TO COVER FINANCING

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PAGE 02 LONDON 14244 02 OF 03 091808Z

NEEDS THAT CAN BE FORESEEN THIS YEAR AND NEXT. (IN REPLY TO QUESTION, HE ADDED THAT UK PUBLIC SECTOR BORROWING IN EUROMARKETS PROJECTED TO CONTINUE AT SAME HIGH LEVEL AS IN RECENT PAST.)

7. SOURCE THOUGHT AN APPROACH TO IMF IN SPRING OF 77 RATHER THAN LATE 1976 COULD BE MORE DIFFICULT. EARLY NEXT YEAR, DISCUSSION WILL BE UNDERWAY ON STAGE 3 OF THE INCOMES POLICY, AND THERE IS A FAIR QUESTION WHETHER OR NOT IT WILL HOLD TOGETHER. IF STAGE 3 (TO BECOME OPERATIVE IN AUGUST 77) INCLUDES FLEXIBILITY, THOSE NEGOTIATIONS UNDER STAGE 2 IN FIRST HALF 1977 MAY BECOME MORE DIFFICULT TO KEEP WITHIN BOUNDS. IN ADDITION, BY SPRING, THE PUBLIC EXPENDITURE WHITE PAPER WILL HAVE BEEN PUBLISHED AND THE CABINET WILL BE INVOLVED IN RUN UP TO BUDGET DECISIONS AND POLICIES. THERE IS A QUESTION WHETHER THE UK SHOULD USE IMF CONDITIONALITY AS AN EXCUSE IN DISCUSSIONS WITH THE TUC, OR WHETHER IT SHOULD USE THE TUC AS AN EXCUSE IN DISCUSSIONS WITH THE IMF. PERHAPS THE END RESULT WILL BE A BIT OF BOTH. THIS SAID, AS CURRENT INCOMES POLICY BITES INTO DISPOSABLE INCOME, WITH UNEMPLOYMENT EXPECTED TO REMAIN HIGH, AND WITH ADDITIONAL IMF CONDITIONALITY EXPECTED AS A QUID PRO QUO FOR BORROWING, HMT EXPECTS TO AGAIN HEAR A RISING CHORUS OF CALLS FOR WIDER IMPORT CONTROLS AND FOR A SEIGE ECONOMY AS AN ALTERNATIVE TO GIVING INTO THE FOREIGNERS. SOURCE DID NOT CONSIDER THERE WOULD BE ANY SERIOUS CALLS FOR REFLATION SAYING "THIS LESSON HAS BEEN LEARNED"

8. DURING ABOVE DISCUSSION, SOURCE WHO IS SENIOR AND CLOSE TO CHANCELLOR HEALEY AND SIR DEREK MITCHELL, STRESSED THAT HE WAS GIVING HIS OWN VIEWS OF THE CURRENT SITUATION. VACATION SCHEDULES CREATED GAPS IN TREASURY DURING AUGUST. IT IS ONLY NOW THAT SENIOR OFFICIALS ARE BEGINNING TO FOCUS ON THE ALTERNATIVE POLICY CHOICES THAT COULD BE PUT TO THE CHANCELLOR.

9. TURNING BRIEFLY TO SUBSTANCE RATHER THAN DETAILS OF SEPTEMBER 10 EC MONETARY COMMITTEE MEETING, SOURCE SAID HE THOUGHT THE ORT PROPOSALS ON TARGET ZONES COULD BE USEFUL IF THEY WERE SUFFICIENTLY FLEXIBLE. IT WILL BE HARD

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PAGE 03 LONDON 14244 02 OF 03 091808Z

TO DEFINE, HOWEVER, BECAUSE TOO NARROW A DEFINITION GIVES A SNAKE, TOO WIDE A DEFINITION REMOVES THE TARGET ZONES. SOME ELEMENT OF CARROT AND SNAKE AND CONDITIONALITY WILL HAVE TO BE CONSIDERED. SOURCE DID NOT BELIEVE EC COMMISSION PROPOSALS ON TWO-TIER SNAKE HAVE MUCH MERIT. GERMAN PROPOSALS FOR BETTER COORDINATION OF MONETARY POLICY DO NOT EVOKE GREAT ENTHUSIASM. ON ALL THESE POINTS, NOTHING CONCRETE IS EXPECTED IN THE NEAR FUTURE AND ALL WILL REQUIRE MORE STUDY. IN REPLY TO QUESTION, SOURCE WOULD NOT COMMENT ON WHY SIR DEREK MITCHELL WAS ATTENDING THIS PARTICULAR MEETING, OTHER THAN TO SAY KARL OTTO POEHL INDICATED IT WOULD BE NICE TO SEE HIM, THEN SOURCE ADDED, ALMOST AS AN AFTERTHOUGHT, THAT ITALIANS, UNDER AGENDA ITEM ON IMF/IBRD ANNUAL MEETING PREPARATION, WANTED TO DISCUSS PROPOSAL THAT THE IMF SHOULD SUSPEND FURTHER GOLD SALES.

10. A SEPARATE CONVERSATION WITH SENIOR ADVISER AT THE

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PAGE 01 LONDON 14244 03 OF 03 091808Z

44

ACTION EB-04

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C O N F I D E N T I A L SECTION 03 OF 03 LONDON 14244

LIMDIS GREENBACK

BANK OF ENGLAND CONFIRMED MUCH OF THE ABOVE. THIS SOURCE SUMMARIZED DEVELOPMENTS IN AUGUST AS NOT SHOWING MUCH CHANGE. THE POUND HAD A FEW FLURRIES. PRESSURE THIS WEEK IS MORE SERIOUS WITH THE BANK HAVING TO SPEND FAIRLY HEAVILY, RAISING POSSIBILITY OF FURTHER DRAWINGS ON THE SWAP LINE.

11. BANK OF ENGLAND OFFICIAL WAS LESS PESSIMISTIC ABOUT BALANCE OF PAYMENTS OUTLOOK NEXT YEAR THAN TREASURY SOURCE, INDICATING HE DID NOT NECESSARILY AGREE WITH NIESR AND LONDON BUSINESS SCHOOL FORECASTS SHOWING RENT ACCOUNT DEFICIT IN RANGE OF 1.5 TO 1.8 BILLION POUNDS LATER BECAUSE OF SLOWER DOMESTIC GROWTH. EARLIER GOVERNMENT FORECASTS HAD UNDERESTIMATED THE HIGH LEVEL OF UNEMPLOYMENT THAT WILL CONTINUE IN 1977. IN ADDITION, INFLATION WILL NOT BE REDUCED AS QUICKLY AS ORIGINALLY FORESEEN. THIS WILL BITE HARDER INTO REAL DISPOSABLE INCOME, REDUCING IT MORE THAN INITIALLY EXPECTED. THIS POINT HAS NOT YET BEEN FULLY TAKEN IN BY THE TRADE UNIONS LEADERS AND RANK AND FILE. BANK OF ENGLAND IS CONCERNED ABOUT THEIR EVENTUAL REACTION.

12. BANK FORECASTERS ARE ALSO CONCERNED ABOUT SLOWER GROWTH TRENDS IN GERMANY, JAPAN AND FRANCE. THEY ACCEPT U.S. STATEMENTS THAT OUR ECONOMY WILL CONTINUE ON AN UP-CONFIDENTIAL

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PAGE 02 LONDON 14244 03 OF 03 091808Z

WARD PATH, BUT THEY ARE BEGINNING TO QUESTION OVERALL WORLD GROWTH OF EXPORTS AND ASSESS LIKELY IMPACT ON GROWTH OF U.K. EXPORTS, WHICH ARE VIEWED AS COMPETITIVE.

13. GOVERNOR OF BANK OF ENGLAND RICHARDSON IS REPORTEDLY ADAMANT THAT ANY OUTSTANDING SWAPS WILL BE REPAID ON DECEMBER 9 -- SOURCE STRESSED HE WAS IN NO WAY IMPLYING THAT CHANCELLOR IS ANY LESS ADAMANT THAN THE GOVERNOR. RICHARDSON, HOWEVER, IS PERSONALLY COMMITTED AS THE MAN ON ONE END OF THE TELEPHONE WHEN THE PACKAGE WAS PUT TOGETHER.

14. AS YET, NO DECISION HAS BEEN MADE CONCERNING AN APPROACH TO THE IMF. SOURCE NOTED THAT IF THE U.K. WENT FOR THE SECOND TRANCHE PLUS THE ADDITIONAL 45 PERCENT CREDIT FROM THE FIRST AND SECOND TRANCHE, THIS HOPEFULLY WOULD BE ENOUGH TO COVER THE PAYMENT OF CREDIT LINE DRAWINGS, BUT IT WOULD LEAVE THE RESERVES AT A FAIRLY LOW LEVEL. IN HIS OPINION, THE U.K. WOULD NEED A FURTHER STANDBY IN ADDITION TO A SECOND TRANCHE DRAWING. HE NOTED THAT THIRD AND FOURTH TRANCHE STANDBY AND DRAWINGS REQUIRE MORE CONDITIONALITY. HE WONDERED ABOUT THE TIMING, NOTING THE ATTITUDE OF GAB MEMBERS WOULD BE CRUCIAL

AND THAT SOME OF THESE WOULD BE IN ELECTION PERIODS. THE ADDITIONAL 45 PERCENT ELEMENT MIGHT RAISE SOME LEGAL PROBLEMS, BUT THIS SHOULD BE SOLVABLE. TURNING AGAIN TO CONDITIONALITY, THE SOURCE WONDERED IF ANY ADDITIONAL MEASURES COULD BE SOLD TO THE CABINET AND THE TUC BEFORE THE NEXT BUDGET. HE WAS QUITE SKEPTICAL OF THE GOVERNMENT'S ABILITY TO TAKE FURTHER HARD MEASURES, SAYING THERE REALLY IS NO FIRM UNDERLYING ECONOMIC FRAMEWORK IN THE GOVERNMENT'S POLICIES. RATHER IT JUST BUMBLES ALONG.

15. THE EXCHANGE MARKET HAD ALSO BEEN INFLUENCED NEGATIVELY BY THE SECOND QUARTER BALANCE OF PAYMENTS FIGURES WHICH RECEIVED A BAD PRESS, ESPECIALLY WITHDRAWALS BY OFFICIAL HOLDERS. AS YET, THERE HAS BEEN NO SIGNIFICANT REFLOW OF FUNDS SINCE THE \$5.3 BILLION CREDIT WAS ANNOUNCED; BANK OF ENGLAND OFFICIALS ARE NOT CONVINCED THERE WILL BE A REFLOW IN THE FUTURE. NEXT ISSUE OF BANK OF ENGLAND QUARTERLY WILL HAVE SPECIAL ARTICLE EXPLAINING
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PAGE 03 LONDON 14244 03 OF 03 091808Z

WHERE PRESSURE POINTS WERE THAT AFFECTED STERLING.

16. DISCUSSING POTENTIAL BAD NEWS, SOURCE INDICATED THAT THE GOVERNMENT BEGAN HAVING DIFFICULTY DURING AUGUST IN SELLING GILTS TO THE NON-BANK PRIVATE SECTOR. WHICH IS HOLDING OFF IN ANTICIPATION OF HIGHER INTEREST RATES. (BY IMPLICATION, THIS COULD INDICATE AUGUST AND SEPTEMBER MONEY SUPPLY FIGURES WILL SHOW LARGER RATES OF INCREASE AS A RESULT OF DEBT SALES TO THE BANKING SYSTEM.)

17. SOURCE REPORTED THAT DISCUSSION OF TARGET ZONE PROPOSALS AND MONETARY POLICY COORDINATION IN EC MONETARY COMMITTEE AND EC CENTRAL BANK GOVERNORS' COMMITTEE WILL PROCEED AT A LEISURELY PACE. HE SAW NO PARTICULAR DEVELOPMENTS OF INTEREST ARISING IN THE RUN UP TO THE MANILA IMF-IBRD SESSION, EXCEPT PERHAPS FURTHER BAD NEWS ON THE U.K. DOMESTIC FRONT.
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